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IN THE

Supreme Court of the United States

October Term, 1959.

No. ~~578~~ 19

W. STUART EMMONS,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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OCTOBER TERM, 1959.

No.

W. STUART EMMONS,

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v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in the above-entitled case on September 9, 1959, affirming the decision of The Tax Court of the United States.

OPINIONS BELOW.

The opinion of The Tax Court (R. 42a) is reported in 31 T. C. 26 (October 13, 1958). The opinion of the Court of Appeals for the Third Circuit is reported at 270 F. 2d 294.

JURISDICTION.

The judgment of the Court of Appeals was entered September 9, 1959. The jurisdiction of this court is invoked under section 1254(1) of the Judicial Code, 28 U. S. C. Sec. 1254(1).

QUESTION PRESENTED.

Whether an amount paid to an insurance company as interest on a loan secured by a fully paid annuity policy issued by the insurance company granting the loan, which policy was purchased prior to March 1, 1954, is deductible for federal income tax purposes under section 23(b) of the Internal Revenue Code of 1939.

STATUTES INVOLVED.

The pertinent statutes are sections 23(b) and 3791(b) of the Internal Revenue Code of 1939, Title 26 U. S. C., which are as follows:

[Sec. 23]

"In computing net income there shall be allowed as deductions:

"...

"(b) INTEREST. All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

[Sec. 3791]

"(b) RETROACTIVITY OF REGULATIONS OR RULINGS. The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect."

STATEMENT OF THE CASE.

On December 17, 1951, petitioner applied to Standard Life Insurance Company of Indiana for an annual premium annuity, providing for the payment of forty one annual premiums, each in the amount of $2,500.00 (R. 13a).

Petitioner paid the first annual premium in the amount of $2,500.00 with his own funds, and the annuity contract was issued as of December 20, 1951 (R. 13a).

On December 21, 1951, petitioner borrowed the sum of $59,213.75 from Girard Trust Corn Exchange Bank, of Philadelphia, Pennsylvania, on the security of his personal demand note, and used the proceeds of that loan to prepay the remaining forty annual premiums on the annuity contract on a discounted basis, as was permitted under the terms of the contract (R. 13a).

On December 26, 1951, petitioner made application to Standard Life Insurance Company of Indiana for a loan in the amount of $68,364.00, on the security of the annuity contract (R. 14a). This loan was granted, and petitioner paid interest in the amount of $13,627.50 on this loan with his personal check, thereby prepaying said interest to December 20, 1956 (R. 13a). The insurance company issued to petitioner its receipt acknowledging the payment of $13,627.50 as "interest on annuity loan contract =AX53951 to 12 20 1956" (R. 13a-14a). Out of the proceeds of the insurance company loan, petitioner repaid the loan from Girard Trust Corn Exchange Bank, with interest in the amount of $45.55 (R. 14a).

Petitioner, who files his income tax returns on the cash receipts and disbursements basis, claimed the interest paid on both loans as a deduction on his federal income tax return for the year 1951, the year in which it was paid (R. 8a, 12a).

In December 1952, petitioner increased his loan from Standard Life Insurance Company of Indiana from $68,364.00 to $73,728.00, and with his personal check paid

interest on the increased loan for an additional three years, to December 20, 1959, in the amount of $9,699.64 (R. 14a). The insurance company issued to petitioner a receipt for $9,699.64 which designated the payment as "Annuity Loan Interest to December 20, 1959" (R. 14a). Petitioner claimed the interest as a deduction on his federal income tax return for 1952 (R. 8a, 14a).

Prior to his purchase of the annuity contract in question, petitioner had made a study of the applicable laws and regulations and relied upon the interpretation of the internal revenue laws as expressed in a large number of rulings issued by the Internal Revenue Service to various taxpayers, all of which held that payments of interest, under circumstances identical with those here existing, were proper deductions in computing taxable income (R. 19a-21a). He also relied upon the statement of Senator George, Chairman of the Senate Finance Committee, in an August 23, 1951, letter to Congressman McConnell in which it was made evident that the Committee had studied the question of interest deductions in connection with annuity loans, but had seen no reason to apply to those loans the same limitations which had been made applicable to deductions for interest payments on loans made to purchase or carry single premium life insurance or endowment policies (R. 22a-23a).

As to the interest payment made in December 1952, petitioner relied upon these same rulings, and in addition relied upon other later rulings of the Commissioner, issued after his purchase of said annuity but prior to his payment of such additional interest (R. 25a-27a).

Following a trial before Judge Forrester of The Tax Court of the United States, at which testimony was taken and during which the rulings and Senator George's letter above referred to were submitted and received in evidence, the Tax Court, on October 13, 1958, entered a decision sustaining the Commissioner's disallowance of these amounts as deductible interest payments (R. 42a-51a).

The Court of Appeals affirmed the decision of the Tax Court.

Jurisdiction of the Tax Court was based upon section 7442 of the Internal Revenue Code of 1954 and section 272 of the Internal Revenue Code of 1939. The appeal to the Court of Appeals from the Tax Court decision was based upon section 7482 of the Internal Revenue Code of 1954.

REASONS FOR GRANTING THE WRIT.

This case presents for the first time in this Court an important question of federal income taxation with respect to which there is a clear conflict of decisions as between the Court of Appeals for the Third Circuit which decided the instant case, and the Court of Appeals for the Fifth Circuit which held in favor of the taxpayer on the identical question in *United States v. Robert R. Bond*, 258 F. 2d 577 (1958), aff'g. 57-1 USTC ¶ 9680 (S. D. Tex. 1957) (not officially reported). This conflict was recognized by the Court of Appeals for the Third Circuit in its opinion in this case.

The court below has decided an important and continuing question of federal income tax law which has not been, but should be, settled by this Court inasmuch as there are a great many cases involving the identical issue presently pending in the various courts of appeal, district courts, and in The Tax Court of the United States.[1]

1. Among these cases known to petitioner are the following: *Karl F. Knetsch*, 59-2 USTC ¶ 9767 (9th Cir. November 16, 1959) (not officially reported), aff'g. 58-2 USTC ¶ 9935 (S. D. Cal. 1958) (not officially reported); *Robert M. Digas*, 18 T. C. M. 443, T. C. Memo Op. 1959-99 (1959), on appeal to the Second Circuit; *Oliver L. Williams*, 18 T. C. M. 205, T. C. Memo Op. 1959-45 (1959), on appeal to the Third Circuit; *D. M. Haggard v. United States*, 59-1 USTC ¶ 9299 (D. Ariz. 1959) (not officially reported); *Dorrance D. Roderick*, 59-2 USTC ¶ 9650 (W. D. Tex. August 5, 1959) (not officially reported); *Henry C. Rogers*, T. C. Dkt. 70765; *William K. Carpenter*, T. C. Dkt. 65446; *Bayard Sharp*, T. C. Dkt. 67317;

This case presents an important issue relating to the power of Congress to limit the retroactive effect of changed rules regarding federal income tax matters.

This case presents an important issue relating to the right of the Commissioner of Internal Revenue to exercise his discretionary authority to change his position as evidenced by letter rulings in cases of taxpayers who have sought and relied upon such rulings while continuing to apply such favorable rulings only in the case of those taxpayers to whom the favorable letter rulings were addressed.

1. There Is a Conflict Between the Decision of the Court Below and the Decision of the Court of Appeals for the Fifth Circuit on an Important and Continuing Problem of Federal Tax Law.

The single basic issue in this case is whether certain payments constituted interest deductible under section 23(b) of the Internal Revenue Code of 1939. Basing its decision almost solely upon the ground that the transaction which gave rise to the interest payments in this case lacked economic substance, the court below held that the payments were not deductible under that section. The Court of Appeals for the Fifth Circuit, on the other hand, after thoroughly analyzing the legislative history of the provisions of the Internal Revenue Codes of 1939 and 1954 relating to the deductibility of interest, held that Congress intended payments such as those involved in this case to be deductible as interest.

Hendler v. Commissioner, T. C. Dkt. 65077, and *Timothy L. Hall*, T. C. Dkt. 65048.

The question presented here has been eliminated by the Internal Revenue Code of 1954 with respect to annuity contracts purchased after March 1, 1954. However, the question remains alive because of the pendency of the listed cases and because the provision of the Internal Revenue Code of 1954 does not disallow the deduction for such payments in connection with contracts purchased on or before March 1, 1954, even though such payments may be made during 1955 and later years. See *Commissioner v. Libson*, U. S. L. Week (U. S., November 10, 1959).

The legislative history of the pertinent sections of the Internal Revenue Codes conclusively demonstrates that Congress intended payments such as those made by petitioner to be deductible except as to annuities purchased after March 1, 1954.

Congress, in enacting the internal revenue laws, has provided that under special circumstances what would otherwise be considered deductible "interest" shall not be deducted in computing taxable income. For example, under section 24(a)(6) of the Internal Revenue Code of 1939, Congress provided that there should be no deduction for "Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. . . ."[2] It has never been contended by the government that the last-quoted statutory language serves to disallow the interest deduction claimed by the petitioner in this case. Neither the last-quoted statutory provision nor any other statutory provision in effect during the calendar years 1951 and 1952 expressly or impliedly denied a deduction for interest paid under the circumstances present in this case.

The legislative history of section 24(a)(6) of the Internal Revenue Code of 1939 quoted *supra* conclusively demonstrates that Congress had deliberately avoided the denial of a deduction for interest under the circumstances of this case.

In section 23(b) of the Revenue Act of 1932,[3] there was a provision for disallowance of interest "on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity." However, in the Revenue Act of 1934,[4] Congress removed this prohibition against deduc-

2. Other examples are interest on loans to carry securities the interest on which is tax free, section 23(b) of the Internal Revenue Code of 1939, and accrued interest payable to a related person under certain circumstances, section 24(c) of the Internal Revenue Code of 1939.

3. 47 Stat. 179 (1932).

4. 48 Stat. 680 (1934).

tion of interest on loans used for purchasing or carrying annuity contracts. This was explained in the Finance Committee Report as follows:

> "The existing law [section 23(b) of the Revenue Act of 1932] also prohibits the deduction with respect to interest paid or accrued on indebtedness incurred or continued to purchase or carry an annuity. The House bill enlarges this prohibition to apply if the proceeds of the indebtedness are actually used in purchasing or carrying an annuity. The theory for not allowing the deduction in such cases is that, since the annuitant was not required to report annuity payments as income (until they exceeded his capital investment), he ought not to be permitted to reduce his taxable income by the allowance of such a deduction. However, since the annuitant is required under the bill to include in income a certain part of the annuity payment received each year, your committee is of the opinion that *the reason for denying the interest deduction in such cases no longer exists.* Accordingly, your committee recommends the omission from the bill of the provision prohibiting the deduction of interest on indebtedness incurred, or continued, or the proceeds of which were used, in connection with the purchasing or carrying of an annuity." " (Italics added.) S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

In 1942, Congress amended the Internal Revenue Code of 1939 to expressly deny a deduction for interest on loans incurred or continued to purchase a single premium life insurance or endowment contract.[5] Section 24(a)(6) of the Internal Revenue Code of 1939, as added by section 127 of the Revenue Act of 1942.[5] Significantly, Congress did not adopt any statutory provision denying an interest deduction with respect to loans incurred in connection with annuity contracts. This was explained in an August 23, 1951, letter

5. 56 Stat. 798 (1942).

from Senator Walter F. George (Chairman of, or ranking minority member of, the Finance Committee, from 1941 to 1953 and a member of the Finance Committee until 1956) to Representative McConnell (R. 52a) on the basis that in 1942 the Committee (of which Senator George was then Chairman), while being advised that certain abuses were present in connection with deduction of interest on loans to carry life insurance contracts, had not been informed of similar abuses in the case of loans to carry annuity contracts.

It was not until the enactment of the Internal Revenue Code of 1954 that Congress provided for the disallowance of a deduction for interest on loans incurred to purchase or carry a single premium annuity contract. Section 264(a)(2) of the Internal Revenue Code of 1954.[6]

For several years prior to 1954, the Bureau of Internal Revenue had been aware of the problems posed by the deduction of interest under the circumstances present in this case and had issued a large number of rulings holding that interest payments such as those made by petitioner were deductible for federal income tax purposes.

Plans such as that involved in the instant case were brought to the attention of the Ways and Means Committee in connection with its consideration of the Internal Revenue Code of 1954. The Ways and Means Committee report explaining the section of the bill which ultimately became section 264(a)(2) of the Internal Revenue Code of 1954 stated:

> "Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded

[6] 68A Stat. 77 (1954).

single premium life insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest below the increment in value produced by the annuity.

"The bill will deny an interest deduction in such cases but only as to annuities purchased after March 1, 1954." H. R. Rep. 1337, 83d Cong., 2d Sess. 31 (1954).

To the same effect, see the Senate Finance Committee report, Sen. Rep. 1622, 83d Cong., 2d Sess. 38 (1954).

Section 264(a) of the Internal Revenue Code of 1954 states in part:

". . . Paragraph (2) [relating to disallowance of interest on annuity contract loans] shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

It is difficult to imagine how Congress could have made more clear its intent that interest payments such as those involved in this case were to be deductible for federal income tax purposes so long as the annuity contract involved had been purchased on or before March 1, 1954. The pertinent committee reports make it abundantly clear that Congress in adopting the limitation on effective date of the new provision had in mind exactly this type of case.

It should be noted that the above-quoted effective date provision in section 264(a) of the 1954 Code is not stated in the usual form to the effect that a new provision shall be applicable after a fixed date. Rather, the effective date provision in section 264 (a) is stated in terms of a new rule for contracts issued after March 1, 1954, thus clearly indicating Congressional intent that the new rule shall not apply to

contracts issued on or before that date, even in taxable years following the enactment of the new law.

It is significant that the court which has ruled in favor of the taxpayer on the single issue involved in this case has cited and discussed the provision of section 264(a) of the Internal Revenue Code of 1954 with respect to the effective date of the new rule with respect to denial of interest deductions in connection with annuity contract loans. *United States v. Robert R. Bond*, 258 F. 2d 577 (1958), aff'g. 57-1 USTC ¶ 9680 (S. D. Tex. 1957). It is equally significant that the courts which have ruled in favor of the government on the single issue involved in this case have in their opinions completely ignored the effective date provisions in section 264(a) of the Internal Revenue Code of 1954. Opinions of the Tax Court and the Court of Appeals for the Third Circuit in this case; opinions of the Court of Appeals for the Ninth Circuit in *Knetsch v. United States*, 59-2 USTC ¶ 9767 (November 16, 1959) (not officially reported), and of the District Court for the Southern District of California in the same case, 58-2 USTC ¶ 9935 (1958); opinion of the District Court for Arizona in *Haggard v. United States*, 59-1 USTC ¶ 9289 (1959) (not officially reported); and opinions of the Tax Court in *Robert M. Bragg*, 18 T. C. M. 443 T. C. Memo Op. 1959-99 (1959); and in *Oliver L. Williams*, 18 T. C. M. 205, T. C. Memo. Op. 1959-45 (1959).

It should be noted that where Congress intends to avoid an inference that a statutory change is indicative of prior law, it has expressly so stated in the amending act. See, e.g., Section 212(b), Revenue Act of 1950, 64 Stat. 941 (1950) (Collapsible corporations); Section 303, Revenue Act of 1950, 64 Stat. 950 (1950) (Exempt organizations); Section 326(c), Revenue Act of 1951, 65 Stat. 497 (1951) (Collapsible corporations); Section 5(b), Technical Amendments Act of 1958, 72 Stat. 1608 (1958) (Improper payments to officials of foreign countries); Section 68(c), Technical Amendments Act of 1958, 72 Stat. 1620-1622 (1958) (Exer-

cise or non-exercise of election by employees re annuities under qualified plans).

In the instant case, the Tax Court and the Court of Appeals neither cited nor discussed the provisions of section 264(a) of the Internal Revenue Code of 1954. Instead, both the Tax Court and the Court of Appeals hinged their decisions in large part upon the decision of this Court in *Gregory v. Helvering*, 293 U. S. 465 (1935). To base a decision against the petitioner in this case on the *Gregory v. Helvering* decision is to miss the real and basic holding in the *Gregory* case. In the *Gregory* case, this Court in effect stated that in applying the words of an internal revenue statute the principal inquiry should be with respect to what Congress intended those words to encompass. In that case, the Court concluded that Congress in describing certain forms of corporate reorganizations had meant to describe only those which had bona fide and substantial business purposes. The holding of the *Gregory* case is not to the effect that Congress in all situations intends its statutory language to encompass only transactions with bona fides and substantial business purposes. This is self-evident when it is realized that in the very area in which we are now dealing it has never been questioned that there can be deductions for interest on loans completely unrelated to any transaction involving a business or profit motive.

In applying the *Gregory* decision in this case, the real inquiry is: Did Congress intend to encompass within the statutory term "interest on indebtedness", and thus permit deduction of, payments such as those made by petitioner? Even a cursory study of the legislative history of the statutory provision permitting deduction of interest conclusively shows that Congress intended interest payments such as those made by the petitioner to be deductible for federal income tax purposes, except in the case of loans in connection with annuity contracts purchased after March 1, 1954.

2. The Commissioner's Position in This Case Is Contrary to His Prior Rulings, Relied Upon by the Petitioner, and Contrary to the Clearly Manifested Intent of Congress.

At the time petitioner paid interest to the Standard Life Insurance Company of Indiana, he was aware of, and relying upon, a number of rulings of the Bureau of Internal Revenue unequivocally holding that interest payments such as those he proposed to make would be deductible for federal income tax purposes. As early as 1947, one of these rulings was published in a widely circulated tax service. 1947 Prentice-Hall Federal Tax Service ¶ 46,145.

The disposition of numerous cases of those taxpayers who received favorable Bureau of Internal Revenue rulings on the very issue here involved was what the Court of Claims has aptly referred to as the "law in action." *Connecticut Railway and Lighting Company v. United States*, 142 F. Supp. 907 (Ct. Cls. 1956), where in discussing the fact that for thirty years the Bureau of Internal Revenue had stood by a position it was attempting to repudiate in that case the court stated:

> "... We think that the law in action cannot be so divorced from the law in the books as to make the latter applicable only to an occasional unfortunate who happened to pay his taxes on the basis of the law in the books. The Government's disclaimer of reliance upon the 1952 regulation with its express provision for discrimination cannot erase the fact of the discrimination." 142 F. Supp. at 909.

There is no doubt that prior to March 15, 1954, the well-known position of the Commissioner of Internal Revenue, expressed in numerous rulings, was that the interest deduction, for which the petitioner now contends, was allowable.

On March 15, 1954, the Commissioner announced what amounted to a change of position in this area by publishing

Revenue Ruling 54-94, 1954-1 C. B. 53. In that ruling, the Commissioner announced that under the circumstances somewhat like those in this case an interest deduction was not allowable. So far as can be determined, this was the first announcement of the Commissioner's change of position in this area and constituted a complete reversal of prior rulings.

There is no indication in Revenue Ruling 54-94, *supra*, regarding the retroactive effect of the new ruling.

Section 3791(b) of the Internal Revenue Code of 1939 authorized the Secretary of the Treasury or the Commissioner of Internal Revenue, with the approval of the Secretary, to prescribe the extent to which any Internal Revenue Service ruling shall be applied without retroactive effect. At first blush, this statutory provision would seem to permit the Commissioner practically unlimited discretion in the matter of applying new rulings with retroactive effect. However, this provision has been construed as being limited by the rule of law which prevents abuse of administrative discretion. *Lesavoy Foundation v. Commissioner*, 238 F. 2d 589, 591 (3rd Cir. 1956), rev'g. 25 T. C. 924, where Judge Goodrich, in the course of his opinion, stated:

> ". . . We quite realize that the Commissioner may change his mind when he believes he has made a mistake in a matter of fact or law. Our own decision in *Keystone Automobile Club v. Commissioner*, 181 Fed. (2d) 402 (3rd Cir. 1950) recognizes this point fully and that point is sustained by abundant authority. But it is quite a different matter to say that having once changed his mind the Commissioner may arbitrarily and without limit have the effect of that change go back over previous years during which the taxpayer operated under the previous ruling."

The attempt to retroactively apply Revenue Ruling 54-94 to the petitioner constitutes an obvious abuse of discretion involving, as it does, penalization for reliance on

prior rulings and blatant discrimination as between taxpayers.

In 1957, the Subcommittee on Internal Revenue Taxation of the Ways and Means Committee of the House of Representatives held hearings on various matters associated with the administration of the internal revenue laws. At a hearing of the Subcommittee held January 18, 1957, Assistant Commissioner of Internal Revenue Winkle and Harold T. Swartz, then Director of the Tax Ruling Division of the Internal Revenue Service, appeared and were questioned, *inter alia*, regarding the Internal Revenue Service's position in cases such as the petitioner's. Assistant Commissioner Winkle, in response to a question, stated that the Internal Revenue Service, in an attempt to be "fair to taxpayers," generally did not apply new rulings retroactively when it was known that the prior contrary position had been reported in trade journals or tax services.[7] Colin F. Stam, Chief of the Staff of the Joint Committee on Internal Revenue Taxation, then asked Mr. Winkle whether the just stated practice of the Internal Revenue Service had been followed in connection with the rulings on deduction of interest under the circumstances of this case. This question was referred to Mr. Swartz, who conceded that in the case of those taxpayers who had received rulings permitting the deduction of interest, Revenue Ruling 54-94 was not being applied retroactively. See *Progress Report of the Subcommittee on Internal Revenue Taxation to the Committee on Ways and Means*, April 22, 1957, page 192.

The effect of the Internal Revenue Service's practice, as set forth in the statements of Messrs. Winkle and Swartz, is that a taxpayer who received a ruling addressed to him has been permitted to deduct, without challenge, interest under the exact same circumstances as surrounded petitioner's interest payment, while the petitioner, who saw and

7. Note that a ruling favorable to petitioner's position had been published in 1947 Prentice-Hall Federal Tax Service ¶ 19,135.

relied upon the ruling addressed to such other taxpayer, is now penalized by the assessment of a deficiency. Presumably recipients of private letter rulings can deduct their payments identical with those of petitioner even today. Surely such a result is inconsistent with any accepted standards of fair play and uniform treatment of taxpayers. As such it represents a clear-cut abuse of discretion which should not be countenanced.

The latest decision of this Court dealing with the matter of retroactive revocation of Internal Revenue Service rulings is *Automobile Club of Michigan v. Commissioner*, 353 U. S. 180 (1957). There, this Court, while approving the action of the Commissioner in revoking an exemption ruling retroactive to the date of publication of an inconsistent ruling, recognized that the Commissioner's discretion under section 3791(b) of the 1939 Code is limited by a rule forbidding abuse of discretion. The Court expressly noted that the Commissioner had "dealt with petitioner upon the same basis as other automobile clubs." Thus, this Court clearly indicated that a failure to treat taxpayers similarly situated in a uniform manner would be such an abuse of discretion as to call for judicial relief.

The Court of Appeals for the Third Circuit, in commenting on the discrimination and abuse of discretion evidenced by the Commissioner's actions in this area, stated:

> ". . . They [petitioner and the taxpayer in the companion case] are entitled to the same treatment as all other taxpayers similarly situated, i.e., without rulings, no more and no less. This the Commissioner has afforded them."

Such a statement merely begs the question. If such a statement represents a valid answer to an argument that there has been discrimination between taxpayers, we have now made a 180 degree turn from the historical course this and other courts have been steering by insisting upon fair

play, equal protection of the laws, and due process as between the government and its citizens. On this new course, any discriminatory practice can be successfully defended by merely observing that the person against whom the discriminatory practice is invoked has some company in his misery.

If the decision of the Court of Appeals in this case is allowed to stand, the Commissioner will be permitted to limit the retroactive effect of a reversal of a prior published ruling in the case of those taxpayers who can prove that they subscribed to the Internal Revenue Bulletin service, while refusing to limit retroactive effect in the case of taxpayers who do not subscribe to the Internal Revenue Bulletin service. Such a classification of taxpayers makes no more sense than a classification based upon those whose names appear on private rulings and those who see and read private rulings addressed to other persons. This is particularly so when it is realized that in the instant situation we are not dealing with the case of a single isolated ruling issued by a minor employee of a government agency. Rather, this situation presents a case of a series of widely circulated rulings issued by the national office of the Bureau of Internal Revenue.

The position of the Commissioner in this case is directly contrary to the intent of Congress as demonstrated by the fact that section 264(a) of the Internal Revenue Code of 1954 expressly provided that the rule of that section was to apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

The determination of policy in the field of taxation is the responsibility of Congress. If Congress determines that payments such as those made by petitioner should be deductible for federal income tax purposes, it is not proper for a court or the Commissioner of Internal Revenue to determine that Congress acted unwisely and to substitute its judgment for that of Congress.

CONCLUSION.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12,844

CARL E. WELLER AND EMILY F. WELLER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 12,854

W. STUART EMMONS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITIONS FOR REVIEW OF DECISIONS OF THE TAX COURT OF THE UNITED STATES

Argued June 9, 1959

Before BIGGS, *Chief Judge*, and MCLAUGHLIN and STALEY, *Circuit Judges.*

Opinion of the Court

(Filed September 9, 1959)

By STALEY, *Circuit Judge*.

These cases present identical questions of law,[1] namely, whether the Tax Court erred in holding that certain transactions involving prepayment of interest on annuity contract loans lacked substance so as not to be deductible as interest payments under Section 23(b) of the Internal Revenue Code of 1939.

The essential facts in the Emmons case, as found by the Tax Court, may be summarized as follows: Emmons, a cash basis taxpayer, purchased an annual premium annuity policy from Standard Life Insurance Company of Indiana in 1951. The policy required forty-one annual payments of $2,500 each, and the initial premium was paid on December 20, 1951, the date of issuance of the policy. The next day Emmons borrowed on his personal note $59,213.75 from the Girard Trust Corn Exchange Bank, pledging the annuity policy as collateral. This sum was credited to the account of the insurance company as a prepayment, at a discount, of all future premiums on the annuity policy.

On December 24, 1951, Emmons paid an additional $13,627.30 to Standard purportedly as interest to December 20, 1956, on an anticipated loan and received in return a receipt designating the payment as "Interest on Annuity Loan Contract No. AX 53651 to December 20, 1956." Following this payment the "cash or loan" value of the annuity contract had increased to $85,361. The petitioner received exactly that amount on December 27, 1951, and executed an agreement designated "Annuity Loan Agreement," providing for interest at 4 per cent per annum

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[1] The cases were tried separately in the Tax Court and are separately in this court, however, inasmuch as the Tax Court on the reasoning in the Emmons case as dispositive of both and facts differ in no material particulars, we will consider them together. Cases reported below: W. Stuart Emmons v. Commissioner of Internal Revenue, 31 T.C. No. 4 (1958), reversed by full court (Raum, J., dissenting without opinion); Carl F. Weller v. Commissioner of Internal Revenue, 31 T.C. No. 5 (1958).

That same day Emmons repaid the bank the earlier loan, utilizing part of the proceeds of the annuity loan.

One year later, on December 31, 1952, Emmons paid Standard the additional amount of $9,699.64 and received a receipt indicating the payment was for "Annuity Loan Interest to December 20, 1959." The discount rate for prepayment of interest was 2.85 per cent. Thus, the second prepayment of interest increased the cash or loan value of the annuity contract to $73,728 and the increase of $5,364 was received by the taxpayer on the same day. Upon receipt, Emmons executed a second "Annuity Loan Agreement." At the date of the proceeding in the Tax Court the "loans" had not been repaid.

Emmons deducted the $13,627.30 payment as interest in his income tax return filed for 1951 and the $9,699.64 payment in his 1952 tax return. The Commissioner disallowed both deductions, insisting that (1) no indebtedness arose upon which payments of interest may be predicated, and (2) the payments constituted premiums rather than interest.

In arriving at its decision, which was reviewed by the full court, the Tax Court concluded that, despite the fact that the payments in question were in form interest within the meaning of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacked substance and therefore was to be ignored for tax purposes.

The facts in the Weller case, except for dates and amounts, are practically the same.

Petitioners' attack on the judgments is essentially twofold. They assert that the payments clearly constituted interest within the meaning of Section 23(b) and were therefore deductible under that section. Additionally, they contend that the Commissioner may not, under the circumstances of these cases, retroactively reverse his prior rulings which allowed similar deductions.

Section 23 of the Internal Revenue Code of 1939, "Deductions from gross income," provides for deductions of

"All interest paid or accrued within the taxable year on indebtedness * * *." The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In old Colony Railroad Co. v. Commissioner of Internal Revenue, 284 U.S. 552, 560 (1932), it was held to be "the amount which one has contracted to pay for the use of borrowed money." Again, in Deputy v. duPont, 308 U.S. 488, 497-498 (1940), the Court stated that "* * * although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of [23(b)]. Nor are all carrying charges 'interest.' * * * We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." Applying these definitions to the instant cases, we come to the crux of the government's case. It contends that since interest for tax purposes is confined to payments for the use of money and since no money or other economic benefit was ever in effect advanced to the taxpayers by the insurance company, the payments were not interest.

The Tax Court, and the government on appeal, rely quite heavily on the pattern of conduct evidenced by the taxpayer and Standard. This pattern, as summarized above, involved prepayments of interest which accelerated the cash or loan value of the policy, concurrent borrowing of the accelerated increase in the cash or loan value, thus immediately recouping a major portion of the purported prepayments of interest. The cycle was completed when the taxpayer claimed deductions on his 1951 and 1952 returns of the entire amounts of each prepayment of interest, although his actual outlay was much less. We agree with the conclusion of the Tax Court that, although in form the payments appear to constitute interest within the meaning

of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacks substance.

Gregory v. Helvering, 293 U.S. 465 (1935), relied upon by the Tax Court, involved the creation of a corporate entity for the purpose of transferring shares of stock to the taxpayer. While recognizing that a real, valid corporate entity was created and that the transaction was within the terms of the statute, the Supreme Court concluded that it was, "an elaborate and devious form of conveyance masquerading as a corporate reorganization." The activities were described as "an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business * * * but to transfer a parcel of corporate shares to the petitioner." The Court there also referred to the rule which excludes from consideration the motive of tax avoidance but determined that it was not pertinent to the situation "because the transaction upon its face lies outside the plain intent of the statute." The question of form versus substance as regards the incidence of taxation has been before the courts on a number of occasions involving numerous differing factual situations. In Higgins v. Smith, 308 U.S. 473, 476 (1940), it was stated that "If * * * the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." See Griffiths v. Commissioner of Internal Revenue, 308 U.S. 355 (1939). In like vein the Supreme Court stated in Commissioner of Internal Revenue v. Court Holding Co., 324 U.S. 331, 334 (1945): "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be

determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

Any case of this nature is beset with difficulties, for in viewing the substance of the entire transaction one is faced with the rule alluded to above that enjoins us to disregard the motive of tax avoidance. That is not to say that we are confronted with a dilemma. Far from it. The proper resolution of the problem has succinctly been set forth by Judge Learned Hand in Gilbert v. Commissioner of Internal Revenue, 248 F.2d 399, 411-412 (C.A. 2, 1957), dissenting on a procedural matter unrelated to this case:

> "* * * If, however, the taxpayer enters upon a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. * * * [The Gregory doctrine] covers only those transactions that do not appreciably change the taxpayer's financial position either beneficially or detrimentally."

Thus, the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally. The words of the statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and "not to include transactions entered upon for no other motive but to escape taxation." Commissioner of Internal Revenue v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (C.A. 2, 1949), cert. denied, 338 U.S. 955 (1950).

The Tax Court could find no independent economic purpose present in the instant cases and thus concluded that the sole purpose was the creation of a tax deduction. The petitioners have gone to great lengths to demonstrate that there was commercial substance to the transactions, over and above the tax benefits, but we are far from convinced. One ignores the practice of concurrently borrowing the increased cash or loan value of the contracts built up by annual payments of interest one might find some economic sense in the transactions, other than the hoped for tax deductions. However, given the practice, which is borne out by the facts, the fact that there was a 4 per cent interest rate on the loans and a more 2.85 per cent discount rate on the prepaid interest, and the fact that the loans were not secured by insurance and were never repaid, the conclusion of the Tax Court is a reasonable one.

Petitioners, on the other hand, point out that the insurance company, which was regularly organized and authorized to issue annuity contracts, and to make loans such as those made here, treated the payments on its books as interest received. The government does not challenge the validity of the labels employed by the insurance company, nor does it contest the validity of the transactions under the insurance laws. Rather, it points to the well settled principle that for the purpose of the federal tax laws, the substance of transactions is to be determined uniformly in relation to the meaning and intendment of the federal laws. United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953). A denial of these claimed deductions would represent no attack in any way upon the insurance laws of Indiana or any other state in which Standard operates nor would it characterize it a "sham corporation" "issuing sham policies." That there may be an obligation which is valid under local law is not determinative of whether there is a true indebtedness within the meaning of Section 23(b). See Haffenreffer Brewing Co. v. Commissioner of Internal Revenue, 116 F.2d 465 (C.A. 1, 1940), cert. denied, 313 U.S. 567 (1941).

Petitioners also place considerable emphasis upon the provisions and legislative history of Section 24(a)(6) which prohibits deductions for certain specified forms of interest, that is, "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract * * *." The fact that annuity contracts are not covered by this prohibition is clear beyond peradventure of a doubt. However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are not deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible.

In disallowing the interest in these cases, the department relied upon Revenue Ruling 54-94, 1954-1 Cum. Bull. 53, which, of course, was issued after the taxable years in question. The petitioners contend that the Commissioner may not retroactively reverse his prior rulings which allowed similar deductions. The prior rulings had not been issued to the petitioners, for they had never requested any but were individual rulings in other cases. These individual rulings had been shown to petitioners by insurance company salesmen prior to the time of the purchase of the annuity contracts. Recognizing that they may not rely on these rulings directly, petitioners maintain that all taxpayers have the right to be treated equally and fairly and since they undoubtedly would have received similar rulings had they applied for them, they are entitled to their benefits. They argue further that the very number of individual rulings made by the Commissioner established a practice.

2 Although there is no evidence in the record as to the number of such rulings made by the Commissioner, Emmons testified he had been shown seven and Weller six or seven such individualized rulings.

a course of conduct, and that a retroactive change would be an arbitrary exercise of the authority committed to the Commissioner by Congress.[3]

The first contention has little substance or reason to support it, for it is just another way of stating that anyone who sees a ruling should be allowed to rely on it. Even with respect to rulings *published* in the Internal Revenue Bulletin, the Supreme Court said in Helvering v. New York Trust Co., 292 U.S. 455, 468 (1934):

> "* * * The rulings * * * 'have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law.' See cautionary notice published in the bulletins containing these rulings."

Certainly *unpublished* rulings can be given no greater effect.

In support of their second contention that it would be an abuse of discretion for the Commissioner to retroactively change his practice established by a series of individual rulings, taxpayers rely upon Automobile Club of Michigan v. Commissioner of Internal Revenue, 353 U.S. 180 (1957), and our case of Lesavoy Foundation v. Commissioner of Internal Revenue, 238 F.2d 589 (C.A. 3, 1956). Reliance upon the Lesavoy case is misplaced, for it merely determined that the Commissioner had exceeded his permissible discretion in retroactively withdrawing a ruling issued to a particular taxpayer who had not estopped himself. The Supreme Court in Automobile Club of Michigan v. Commissioner of Internal Revenue, supra, sets forth the standard which we must apply in questions of this nature. In that case, the petitioner automobile club had received a ruling of

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3. Section 3791(b) provides:

"Retroactivity of Regulations or Rulings.—The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect." 53 Stat. 467 (1939), 26 U.S.C.A. I.R.C. 1939, § 3791(b).

exemption from the Commissioner in 1934 which was reconfirmed in 1938. In 1945, applying a new interpretation of the revenue laws rendered by the General Counsel, the Commissioner revoked this individual ruling and applied his revocation retroactively to tax years 1943 and 1944. The revocations applied to exemptions issued to all automobile clubs and the Supreme Court stated, at page 186, "that the Commissioner, having dealt with petitioner upon the same basis as other automobile clubs, did not abuse his discretion." Similarly in the instant cases, the petitioners have been treated in the same manner as all other taxpayers.

Petitioners contend, however, that although the revenue ruling fails to indicate any limitation on its application, agents of the Treasury have stated to Congress that it does not intend to apply the revenue ruling retroactively to individuals who have previously been issued rulings. We need not determine whether such action if carried out would be an abuse of discretion, for petitioners are not in the same position as those parties who have been issued rulings. They are entitled to the same treatment as all other taxpayers similarly situated, i.e., without rulings, no more and no less. This the Commissioner has afforded them.

Petitioners' further arguments are adequately disposed of by Automobile Club of Michigan v. Commissioner of Internal Revenue, supra.

We are not unmindful of the decision recently rendered by the Court of Appeals for the Fifth Circuit in a similar case, United States v. Bond, 258 F.2d 577 (1958), which holds contrary to this opinion. We agree, however, with the dissenting opinion of Judge Wisdom in that case. In accord with our opinion are Haggard v. United States, 59-1 U.S.T.C. ¶ 9229 (D.C. Ariz. 1959); and Knetsch v. United States, 58-2 U.S.T.C. ¶ 9935 (S.D. Calif. 1958). And see Goodstein v. Commissioner of Internal Revenue, 267 F.2d 127 (C.A. 1, 1959); Sonnabend v. Commissioner of Internal Revenue, 267 F.2d 319 (C.A. 1, 1959).

The judgments will be affirmed.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT.

No. 12,854.

W. STUART EMMONS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES.

Present: BIGGS, *Chief Judge*, and MCLAUGHLIN and STALEY, *Circuit Judges*.

Judgment.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

Attest:

HARRIET G. HUMPHREYS,
Chief Deputy Clerk.

September 9, 1959

RECEIVED & FILED
SEP 9, 1959
Ida O. Croskoff
Clerk

19 20

Nos. 573 and 574

In the Supreme Court of the United States

October Term, 1959

W. Stuart Emmons, petitioner

Commissioner of Internal Revenue

[illegible] Wheeler and Emma [illegible] Wheeler, petitioners

Commissioner of Internal Revenue

[illegible]

MEMORANDUM FOR THE RESPONDENT

[illegible]

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 573

W. STUART EMMONS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 574

CARL E. WELLER AND EMILY I. WELLER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The issue presented in each of these cases[1] is whether purported "prepayments of interest" on a "loan"

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[1] The Court of Appeals filed a single opinion in these two cases, noting in a footnote at the outset of its opinion, "The cases were tried separately in the Tax Court and argued separately to this court; however, inasmuch as the Tax Court relied on the reasoning in the *Emmons* case as dispositive of both and as the facts differ in no material particulars, we will consider them together. . . ." (*Emmons*, Pet. 2a; *Weller*, Pet. 18a.)

from the Standard Life Insurance Company of Indiana to the taxpayer are deductible under Section 23(b) of the Internal Revenue Code of 1939. In each case the taxpayer made a relatively small down payment (the first "annual premium"); then prepaid the remaining premiums by means of the "loan" in question (initially secured from a bank but shifted within the same day to the insurance company). The taxpayer was reimbursed in great part for his "prepayments of interest" by concurrent augmentations of the "loan." The Court of Appeals held, in agreement with the Tax Court and the Commissioner, that the "prepayments of interest" did not constitute bona fide "interest * * * on indebtedness" within the meaning of Section 23(b) and hence were not deductible. As the taxpayers point out, this holding is in conflict with *United States* v. *Bond*, 258 F. 2d 577 (C.A. 5th). The court below acknowledged this conflict in the final paragraph of its opinion, stating that it was "not unmindful" of the decision in *Bond*, but that it agreed with the dissenting opinion of Judge Wisdom in that case. (*Emmons*, Pet. 10a; *Weller*, Pet. 27.)

Since the instant decisions were entered, the same issue has been decided in favor of the Government by the Court of Appeals for the Ninth Circuit. *Knetsch* v. *United States*, decided on November 16, 1959 (59-2 U.S.T.C. par. 9767), reprinted in the Appendix, *infra*, pp. 4-5, notes the conflict between the instant decisions and *Bond* and agrees with the instant decisions. Cases presenting and analogous issue as to deductibility of claimed interest payments, also decided in favor of the Government, are *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st); *Lynch* v. *Commissioner*, decided on De-

cember 17, 1959 (C.A. 2d); and *Broome v. United States*, 170 F. Supp. 613 (C. Cls.).

The issue is a recurrent one notwithstanding a provision of the 1954 Code (Section 264(a)(2)) which explicitly bars a deduction for any amount paid on indebtedness incurred or continued to purchase or carry a single premium annuity contract. Inasmuch as this provision is limited in its application to annuity contracts purchased after March 1, 1954, as to contracts issued prior to that date and outstanding thereafter the question remains whether there has been a bona fide payment of interest on indebtedness deductible under Section 23(b) of the 1939 Code and its successor, Section 163(a) of the 1954 Code.[2] Moreover, even "loans" on annuity contracts issued after March 1, 1954, will not be subject to the prohibition of Section 264(a)(2), unless the contracts are single premium contracts as defined in Section 264(b).

Accordingly, although we believe that the decisions below are correct and that the conflicting *Bond* decision is erroneous, we do not oppose certiorari.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.

JANUARY, 1960.

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[2] We are advised by the Internal Revenue Service that there are known to be more than one hundred and thirty such cases in litigation.

APPENDIX

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Nov. 16, 1959

No. 16,356

KARL F. KNETSCH AND EVA FAY KNETSCH, APPELLANTS,

vs.

UNITED STATES OF AMERICA, APPELLEE

Appeal from the United States District Court Southern District of California Central Division

Before: STEPHENS and HAMLIN, Circuit Judges and LINDBERG, District Judge

STEPHENS, Circuit Judge

On December 11, 1953, the taxpayers purchased ten single premium annuity bonds from the Sam Houston Life Insurance Company. The purchase price of $1,004,000 was paid by a note for $4,000,000 and $1,000 in cash. The note was without recourse, and was secured by the annuity bonds. Interest on the note at three and one-half percent per annum, amounting to $140,000 was paid in cash. On December 16, $99,000 was sent to the taxpayers by Sam Houston as an additional loan, and the taxpayers paid the company $3,465 in interest. The bonds bore interest at the rate of two and one-half percent per annum, compounded annually. They matured in thirty years, and at that time would pay the taxpayers a monthly income of $43,00. Maturity could be accelerated or the bonds cashed in, at any time at the taxpayers' option. Mr. Knetsch was sixty when he made the purchase in 1953.

A similar transaction involving an interest payment of $147,105 was entered into for 1954, prior to March 1, when the provisions of the 1954 Internal Revenue Code affecting interest deductions for annuities went into effect.

These interest payments to Sam Houston were claimed as deductions in the taxpayers' 1953 and 1954 tax returns. When the deductions were disallowed, the deficiencies were paid under protest, and suit was brought in the District Court for refund. The District Court found, with ample support in the record, that the annuity bonds provided neither profit nor insurance; that they had been purchased solely to obtain a tax benefit; and that the alleged interest was not interest in fact, but the purchase price of a tax deduction. From that adverse judgment, the taxpayers have appealed.

This case arises under the Internal Revenue Code of 1939, which allows interest[1] as a deduction from gross income. The issue is whether such payments were payments of interest.

The problem has been carefully considered in *United States* v. *Bond*, 5th Cir., 258 F 2d 577, which adopted the viewpoint of the taxpayer; and in *Weller* v. *Commissioner*, 3rd Cir., 270 F 2d 294, which agreed with the arguments of the government. We find ourselves in agreement with the opinion expressed by the judges of the Third Circuit.

The judgment of the District Court is affirmed.

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[1] Section 23(b)